

June 2011

International Financial Reporting Standards



Understanding IFRSs

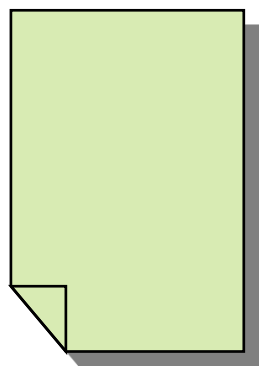
*A Framework-based approach to
applying IFRSs*

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The views expressed in this presentation are those of the presenter,
not necessarily those of the IASB or IFRS Foundation.

Framework-based understanding...

- relates IFRS requirements to the concepts in the *Conceptual Framework*
- reasons why some IFRS requirements do not maximise those concepts (eg application of the cost constraint or inherited requirements)



Concepts



Principles



Rules

The IASB's *Conceptual Framework*

- *Framework* sets out **agreed concepts** that underlie IFRS financial reporting
 - the **objective** of general purpose financial reporting
 - qualitative characteristics
 - elements of financial statements
 - recognition
 - measurement
 - presentation and disclosure

Other concepts all flow from the objective

Objective of financial reporting

“Provide financial information about the reporting entity that is useful to existing and potential investors, lenders and other creditors in making decisions about providing resources to the entity.”

Those decisions involve buying, selling or holding equity and debt instruments, and providing or settling loans or other forms of credit

- Cost
 - IASB assesses whether the benefits of reporting particular information are likely to justify the costs incurred to provide and use that information.

Note: It **is consistent** with the *Framework* for an IFRS requirement not to maximise the qualitative characteristics of financial information and other main Framework concepts when the costs of doing so would exceed the benefits.

Framework-based understanding provides...

- a **cohesive understanding** of IFRSs
 - *Framework* facilitates **consistent and logical formulation** of IFRSs
- a basis for **judgement** in applying IFRSs
 - *Framework* established the concepts that underlie the estimates, judgements and models on which IFRS financial statements are based
- a basis for **continuously updating** IFRS knowledge and IFRS competencies

Example 1a, b and c: errors and changes in policies and estimates

- Objective
- Concepts
 - faithful representation
 - comparability
- Principle
 - **1a Prior period error:** retrospective restatement
 - **1b Change in policy:** retrospective application
 - **1c Change in estimate:** prospective application
- Rules
 - impracticable exception
 - transitional provisions (new requirements)
 - specified disclosures

Example 2: allocating depreciation: concepts

- Information about an entity's financial performance in a period, reflected by changes in economic resources (eg PPE) is useful in assessing the entity's past and future ability to generate net cash inflows (see ¶OB18)
- Expenses are decreases in economic benefits during an accounting period in the form of depletions of assets... (¶4.25)
- Depreciation represents the consumption of the assets service potential in the period.
 - land with an indefinite useful life is not depreciated because its service potential does not reduce with time

Example 2: allocating depreciation: principle

- Depreciation is the **systematic allocation** of the **depreciable amount** of an asset over its **useful life** (IAS16.6).
 - essentially a cost allocation technique (IAS16.BC29)

Example 2: allocating depreciation: application guidance (1)

- Systematic allocation (application guidance):
 - **depreciation method** must closely reflect the pattern in which the asset's future economic benefits are expected to be consumed by the entity.
 - **unit of measure** for depreciation is different from that for an item of PPE. By depreciating significant parts of an item of PPE separately, depreciation more faithfully represents the consumption of the asset's service potential. (IAS16.BC26)

Example 2: allocating depreciation: application guidance (2)

- Depreciable amount =
 - cost model: historical cost less **residual value**
 - revaluation model: fair value less **residual value**
- Residual value =
 - amount that the entity would currently obtain from disposal of asset (less estimated disposal costs) if the asset were already of the age and in the condition expected at the end of its **useful life**

Example 2: allocating depreciation: application guidance (3)

- Useful life (entity specific) =
 - the period over which the asset is expected to be available for use by the entity; or
 - the number of production or similar units expected to be obtained from the asset by the entity.
- Consequently, depreciation **continues when idle** (if useful life = period)
- However, depreciation **ceases when classified as held for sale** because IFRS 5 measurement is essentially a process of valuation, rather than allocation (IFRS5.BC29)

If no specific IFRS requirement

- **Use judgement** to
 - develop a policy that results in **relevant** information that **faithfully represents** (ie complete, neutral and error free)
 - Hierarchy:
 - 1st IFRS dealing with similar and related issue
 - 2nd *Framework* definitions, recognition crit. etc
- Can also in parallel refer to GAAPs with similar Framework

Framework-based approach would ask:

- What is the economics of the phenomenon (eg transaction or event)?
- What relevant information using the accrual basis of accounting faithfully present that economic phenomenon to inform decisions of investors and lenders (potential and existing)?
- Is there anything in IFRSs that prevents me from providing that information?

Example 3: non-cash distribution

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Before IFRIC 17, entity distributes non-cash asset (eg land or shares in another) whose fair value = CU1 mill. Carrying amount of asset = cost = CU1K

- Economics = reduce owners' claims against the entity by distributing to them an asset worth CU1 million.
- Relevant information for investors and lenders that faithfully represents the economics:
 - investors received CU1 million refund of capital.
 - value of assets available to meet lenders' claims reduced by CU1 million.

Example 3: non-cash distribution

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Before IFRIC 17... (continued)

- Does IFRSs prevent providing that information?
No. Therefore:
 - recognise CU999K income (previously unrecognised increase in the value of the asset derecognised).
 - recognise CU1 million distribution to owners.

Example 4: share-based payment

Before IFRS 2, entity pays employee in own shares. Par value of shares issued = CU1K. Fair value of services provided = CU1 million = fair value of shares.

- Economics = entity paid employees CU1 million for services. Employees invested CU1 million in entity.
- Relevant information for investors and lenders that faithfully represents the economics:
 - CU1 million services received = staff cost.
 - CU1 million invested = increased owner equity.
- Does IFRSs prevent providing that information? No. Therefore, recognise CU1 million expense and recognise CU1 million increase in owners' equity.

Common misunderstandings

| The <i>Framework</i> does not... | Clarification—the <i>Framework</i> includes |
|--|--|
| include a matching concept | accrual basis of accounting— recognise elements when satisfy definition and recognition criteria |
| include prudence/conservatism concept | neutrality concept |
| include an element other comprehensive income (or a concept for OCI) | only the following elements— asset, liability, equity, income and expense |
| mention management intent or business model | |

| Misunderstanding | Clarification |
|---|---|
| Principles are necessarily less rigorous than rules | Rules are the tools of financial engineers |
| There are few judgements and estimates in cost-based measurements | Inventory, eg allocate joint costs and production overheads PP&E, eg costs to dismantle/restore site, useful life, residual value, depreciation method Provisions, eg uncertain timing and amount of expected future cash flows |

- IFRS Foundation education initiative works with others to support *Framework*-based teaching
 - create awareness
 - develop material (starting with PPE)
 - hold workshops (in 2011: Vienna with World Bank, Bucharest, Denver, George and Venice with IAAER and Rio with BNDES)
 - encourage those certifying accountants to examine their students' ability to make the judgements that are necessary to apply IFRSs

Questions or comments?

Expressions of individual views by members of the IASB and their staff are encouraged. The views expressed in this presentation are those of the presenter. Official positions of the IASB on accounting matters are determined only after extensive due process and deliberation.

